

Initial Statement of Reasons for
Proposed Amendments to California Code of Regulations,
Title 18, Section 1603, *Taxable Sales of Food Products*

SPECIFIC PURPOSE, PROBLEM INTENDED TO BE ADDRESSED, NECESSITY, AND ANTICIPATED BENEFIT

Current Law

California imposes sales tax on retailers for the privilege of selling tangible personal property at retail. (Rev. & Tax. Code, § 6051.) Unless an exemption or exclusion applies, the tax is measured by a retailer's gross receipts from the retail sale of tangible personal property in California. (Rev. & Tax. Code, §§ 6012, 6051.) The term "gross receipts" means the total amount of the sale price without any deduction for the cost of materials used, labor or service costs, interest paid, losses, or any other expense. (Rev. & Tax. Code, § 6012, subd. (a)(2).) Gross receipts include any services that are part of the sale and all receipts, cash, credits, and property of any kind. (Rev. & Tax. Code, § 6012.) Although sales tax is imposed on retailers, retailers may collect sales tax reimbursement from their customers. (Civ. Code, § 1656.1; Cal. Code Regs., tit. 18, § 1700, subd. (a)(1).)

Sales of food products for human consumption are generally exempt from tax. However, as relevant here, this exemption does not apply to sales of food products furnished, prepared, or served for consumption at tables, chairs, or counters or from trays, glasses, dishes, or other tableware whether provided by the retailer or by a person with whom the retailer contracts to furnish, prepare, or serve food products to others, or to sales of food products served as meals on or off the premises of the retailer. (Rev. & Tax. Code, § 6359.) Therefore, issues arise as to whether payments designated as tips, gratuities, and service charges that are related to taxable sales of food products are includible in retailers' gross receipts.

In addition, Labor Code section 351 provides that no employer or agent shall collect, take, or receive any gratuity or a part thereof that is paid, given to, or left for an employee by a patron, or deduct any amount from wages due an employee on account of a gratuity, or require an employee to credit the amount, or any part thereof, of a gratuity against and as a part of the wages due the employee from the employer. And, this prohibition applies to employers who operate restaurants and similar establishments whose employees receive gratuities from their customers.

California Code of Regulations, title 18, section (Regulation) 1603, *Taxable Sales of Food Products*, provides guidance to restaurants, hotels, boarding houses, soda fountains, and similar establishments that make taxable sales of food products. Under Regulation 1603, subdivision (g), optional payments designated as tips, gratuities, and service charges are not subject to tax (and not included in a retailer's gross receipts); however, mandatory payments designated as tips, gratuities, and service charges are included in gross receipts subject to tax, even if the amount is subsequently paid by the retailer to the server.

Specifically, Regulation 1603, subdivision (g)(1)(A), provides that “[a] payment of a tip, gratuity, or service charge is optional if the customer adds the amount to the bill presented by the retailer, or otherwise leaves a separate amount in payment over and above the actual amount due the retailer for the sale of meals, food, and drinks that include services,” and provides examples illustrating when the payment of an amount designated as a tip, gratuity, or service charge is optional. Also, Regulation 1603, subdivision (g)(1)(B) incorporates the prohibition in Labor Code section 351, and provides that when the “prohibition is violated, any amount of such gratuities received by the employer will be considered a part of the gross receipts of the employer and subject to the tax.”

Regulation 1603, subdivision (g)(2)(A), provides that “[a]n amount negotiated between the retailer and the customer in advance of a meal, food, or drinks, or an event that includes a meal, food, or drinks is mandatory.” Regulation 1603, subdivision (g)(2)(B), provides that “[w]hen the menu, brochures, advertisements or other printed materials contain statements that notify customers that tips, gratuities, or service charges will or may be added, an amount automatically added by the retailer to the bill or invoice presented to and paid by the customer is a mandatory charge and subject to tax,” and provides examples of such printed statements. Regulation 1603, subdivision (g)(2)(B) provides that “[a]n amount will be considered ‘automatically added’ when the retailer adds the tip to the bill without first conferring with the customer after service of the meal and receiving approval to add the tip or without providing the customer with the option to write in the tip.” Also, Regulation 1603, subdivision (g)(2)(B), provides that “any amount added [to the bill] by the retailer is presumed to be mandatory,” and Regulation 1603, subdivision (g)(2)(C), prescribes the type of evidence that must be provided to controvert (or rebut) the presumption and provides examples of such evidence.

On June 25, 2012, the Internal Revenue Service published Internal Revenue Bulletin No. 2012-26, which includes Revenue Ruling 2012-18. This revenue ruling clarified and updated guidelines on taxes imposed on tips under the Federal Insurance Contributions Act, including information on the difference between tips (tip wages) and service charges (non-tip wages). The ruling reaffirmed prior guidance which provided that the absence of any of the four following factors creates a doubt as to whether a payment is a tip and indicates that the payment may be a service charge: 1. The payment must be made free from compulsion; 2. The customer must have the unrestricted right to determine the amount; 3. The payment should not be the subject of negotiation or dictated by employer policy; 4. Generally, the customer has the right to determine who receives the payment.

Proposed Amendments

Interested Parties Process

Although Regulation 1603, subdivision (g), was amended in 2007 to clarify the application of tax to tips, gratuities and service charges, it has become evident to State Board of Equalization (Board) staff that some retailers are having compliance issues because there is still some remaining confusion regarding what constitutes “mandatory” versus “optional” tips, gratuities, and service charges. As a result, the Board’s Business Taxes Committee (BTC) staff prepared

draft amendments to subdivision (g) of Regulation 1603 to address the retailers' compliance issues (or problems within the meaning of Gov. Code, § 11346.2, subdivision (b)) by establishing a new bright-line approach for determining whether payments (or amounts) designated as tips, gratuities, and service charges are "optional" or "mandatory" based upon how the retailer treated the amounts for Internal Revenue Service purposes. The draft amendments suggested adding provisions to the regulation explaining that when a retailer keeps records consistent with reporting amounts as tip wages for Internal Revenue Service purposes, such amounts are presumed to be optional and not subject to tax. The draft amendments also provided that a payment of a tip, gratuity, or service charge is deemed to be mandatory if the amounts are required to be reported, for the purposes of income tax to the Internal Revenue Service, as non-tip wages, and the amendments listed the four factors from Revenue Ruling 2012-18 that the Internal Revenue Service examines to determine if a payment is a tip or service charge (non-tip wage). The draft amendments also clarified subdivision (g)'s existing language and deleted provisions of subdivision (g) that had caused confusion for retailers and staff.

BTC staff subsequently provided its draft amendments to Regulation 1603 to the interested parties and conducted an interested parties meeting in December 2013 to discuss the draft amendments. During the December 2013 meeting, interested parties appeared open to staff's proposal and there was a general consensus that creating a bright-line approach with respect to tips, gratuities, and service charges would be helpful to the restaurant industry and staff. Also, participants discussed the effect of the new presumption and asked BTC staff what would happen if a retailer did not maintain records for purposes of its federal income tax reporting.

Subsequent to the December 2013 interested parties meeting, staff received letters from Kara Bush on behalf of the California Restaurant Association and from James Dumler of McClellan Davis, LLC. Both letters were dated January 10, 2014. (See Exhibits 3 and 4 to Formal Issue Paper 2014-003 referred to below.) In the first letter, Ms. Bush expressed the California Restaurant Association's appreciation of the Board's efforts to clarify this issue and stated that the association looks forward to continuing to work with staff and other interested parties to develop a bright-line approach that will foster reporting compliance and audit efficiency. Ms. Bush also expressed appreciation for staff's suggestions and stated that the association will continue to explore other alternatives. In the second letter, Mr. Dumler reiterated concerns expressed during the interested parties meeting that a taxpayer that lacks support for the IRS tip designations would not benefit from the proposed presumption and optional gratuities could incorrectly be presumed to be mandatory. Mr. Dumler also recommended that the examples in the current regulation with respect to mandatory payments be retained.

In response to the concerns expressed at the December 2013 interested parties meeting, staff added language to its draft amendments clarifying the application of the new presumption regarding federal tax reporting and also added provisions to determine whether a payment is "optional" or "mandatory" when a retailer does not maintain records for purposes of reporting tips to the IRS. When a retailer does not maintain these records, the determination of whether or not the payments are mandatory is consistent with the provisions currently in Regulation 1603, subdivision (g) (discussed above). Additionally, staff added clarifying language to its draft amendments to define the term "amount" as a payment designated as a tip, gratuity, or service charge, or any other separately stated payment for services associated with the purchase of

meals, food, or drinks. This amendment was made to reduce historical confusion associated with the use of the word “amount” to refer to payments throughout Regulation 1603, subdivision (g). Additionally, due to perceived confusion with staff applying the four factors from Revenue Ruling 2012-18 (referred to above), these factors were deleted from staff’s draft amendments.

In February 2014, staff again met with interested parties to discuss the draft amendments. Staff and interested parties discussed how to make it clear that the draft amendments are only to apply prospectively.

Following the February 2014, interested parties meeting, staff received a letter from Mr. Matt Sutton, sent on behalf of the California Restaurant Association. (See Exhibit 5 to Formal Issue Paper 2014-003 referred to below.) In his March 6, 2014, letter, Mr. Sutton explained that while the California Restaurant Association has historically disagreed with the taxation of mandatory gratuities, it was appreciative of staff’s ideas and acknowledged that the suggestions for a “bright line” approach, discussed in the discussion papers and both interested parties meetings, have merit. Mr. Sutton further stated that it remains to be seen how the industry will respond to the Internal Revenue Service guidance and how that will interplay with the Board’s practice of taxing mandatory tips.

May 22, 2014, BTC Meeting

Staff made changes to its draft amendments to Regulation 1603 in response to the discussion of the prospective application of the draft amendments at the February 2014 interested parties meeting. Staff changed the draft amendments so that subdivision (g) of Regulation 1603 continues to apply to transactions prior to January 1, 2015, without any changes, and new subdivision (h), containing what had previously been staff’s draft amendments to subdivision (g), will apply to transactions on and after January 1, 2015. Staff also changed the draft amendments in order to renumber the subdivisions of the regulation following new subdivision (h), and update the regulation’s current cross-references to the renumbered subdivisions.

Subsequently, BTC staff prepared Formal Issue Paper 14-003 and distributed it to the Board Members for consideration at the Board’s May 22, 2014, BTC meeting. Formal Issue Paper 14-003 recommended that the Board propose to add new subdivision (h) to Regulation 1603 to define the term “amount,” and provide that, for sales made on and after July 1, 2015, when a retailer keeps records consistent with reporting amounts as tip wages for Internal Revenue Service purposes, such amounts are presumed to be optional and not subject to tax. Additionally, new subdivision (h) provides that when a retailer’s records reflect that amounts are required to be reported to the Internal Revenue Service as non-tip wages, the amount is deemed to be mandatory. Finally, new subdivision (h) provides that when a retailer does not maintain records for purposes of reporting amounts to the Internal Revenue Service, the application of tax to the amounts will be consistent with the provisions currently in Regulation 1603, subdivision (g), including subdivision (g)’s record keeping requirements and provisions regarding violations of the prohibition in Labor Code section 351. The formal issue paper also recommended making non-substantive amendments to the regulation, including moving the regulation’s authority and reference note so that it precedes the regulation’s appendix, and updating the cross-references to

other regulations following the authority and reference note. (See Exhibit 2 to Formal Issue Paper 14-003.)

The Board discussed Formal Issue Paper 14-003 during its May 22, 2014, BTC meeting. Mr. Matt Sutton appeared on behalf of the California Restaurant Association and made statements similar to those in his March 6, 2014, letter. At the conclusion of the discussion, the Board Members voted 4-0 to propose the amendments to Regulation 1603 recommended in the formal issue paper, subject to conforming to the official text of the regulation at the time of publication. The Board determined that the proposed amendments to Regulation 1603 are reasonably necessary to have the effect and accomplish the specific purpose of addressing the retailers' compliance issues (discussed above) due to the confusion regarding what constitutes "mandatory" versus "optional" tips, gratuities, and service charges.

The Board anticipates that the proposed amendments to Regulation 1603 will promote fairness and benefit retailers, Board staff, and the Board by providing regulatory provisions that may be applied using a bright-line approach that is consistent with federal tax reporting, and thereby reduce confusion for retailers and staff.

In addition, the Board has determined that the proposed amendments are not mandated by federal law or regulations, and there are no federal regulations or statutes that are identical to Regulation 1603 or the proposed amendments to Regulation 1603.

DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 14-003, the exhibits to the issue paper, and the comments made during the Board's discussion of the issue paper during its May 22, 2014, BTC meeting in deciding to propose the amendments to Regulation 1603 described above.

ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt the proposed amendments to Regulation 1603 at this time or, alternatively, whether to take no action at this time. The Board decided to begin the formal rulemaking process to adopt the proposed amendments to Regulation 1603 at this time because the Board determined that the proposed amendments are reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to the proposed amendments to Regulation 1603 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2,
SUBDIVISION (b)(5) AND ECONOMIC IMPACT ASSESSMENT REQUIRED BY
GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

As previously explained, the proposed amendments do not change the rule that an optional payment designated as a tip, gratuity, or service charge is not subject to tax, and a mandatory payment designated as a tip, gratuity, or service charge is includable in taxable gross receipts. The proposed amendments make Regulation 1603's treatment of payments designated as tips, gratuities, and services charges consistent with the records retailers keep for reporting such payments as tip wages or non-tip wages for Internal Revenue Service purposes by adding a new presumption as to whether or not a tip, gratuity, or service charge is subject to tax based on such records. The amendments also clarify subdivision (g)'s existing language regarding the application of tax to payments designated as tips, gratuities, and service charges by adding new subdivision (h) to Regulation 1603, effective for transactions on or after January 1, 2015.

Specifically, new subdivision (h) defines "amount" as a payment designated as a tip, gratuity, service charge, or any other separately stated payment for services associated with the purchase of meals, food, or drinks. New subdivision (h)(1) provides that when a retailer keeps records consistent with reporting amounts as tip wages for Internal Revenue Service purposes, such amounts are presumed to be optional and not subject to tax. When a retailer does not maintain such records, this presumption does not apply. And, new subdivision (h)(1) provides examples of transactions where amounts are optional and not subject to tax, which are consistent with the current examples in Regulation 1603, subdivision (g)(1)(A).

Also as previously explained, new subdivision (h)(2) provides that when a retailer's records reflect that amounts are required to be reported to the Internal Revenue Service as non-tip wages, the amount is deemed to be mandatory. New subdivision (h)(3) prescribes the application of tax when the examples of amounts that are optional in subdivision (h)(1) do not apply and a retailer does not maintain records for purposes of reporting the amounts to the Internal Revenue Service, and new subdivision (h)(3) is consistent with the current provisions of Regulation 1603, subdivision (g)(2). New subdivision (h)(3) provides that when an amount is negotiated between the customer in advance of a meal, food, or drinks, or an event that includes a meal, food, or drinks, the amount is mandatory. When the menu or other printed materials notify customers that amounts will or may be added by the retailer to the bill, and such amounts are automatically added by the retailer to the bill, the amount is a mandatory charge and subject to tax. It is presumed that an amount added by the retailer to the bill is automatically added and mandatory; however, this presumption may be overcome by documentary evidence showing that the customer specifically requested and authorized the amount to be added to the bill.

Also, as previously explained, the proposed amendments are intended to address retailers' compliance issues due to the confusion regarding what constitutes "mandatory" versus "optional" tips, gratuities, and service charges by establishing a bright-line approach to how to treat amounts added by retailers to customers' bills that is consistent with how the retailers treated the amounts for Internal Revenue Service purposes. There is nothing in the proposed amendments to Regulation 1603 that would significantly change how restaurants and similar establishments would generally behave in the absence of the proposed amendments. And, the

Board anticipates that the proposed amendments to Regulation 1603 will promote fairness and benefit retailers, Board staff, and the Board by addressing and reducing such confusion.

In addition, the amendments to Regulation 1603 do not impose any costs on any persons, including restaurant businesses, because the proposed amendments do not impose new record keeping requirements and take into account, rather than impact, current practices in the restaurant industry regarding tips, gratuities, and service charges. And, the proposed amendments do not impact revenue. (See Exhibit 1 to Formal Issue Paper 14-003.) Therefore, the Board estimates that the proposed amendments will not have a measurable economic impact on individuals and business. And, the Board has determined that the proposed amendments to Regulation 1603 are not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000, because the Board has estimated that the proposed amendments will not have an economic impact on California business enterprises and individuals in an amount exceeding fifty million dollars (\$50,000,000) during any 12-month period.

Further, based on these facts and all of the information in the rulemaking file, the Board has also determined that the adoption of the proposed amendments to Regulation 1603 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

Furthermore, Regulation 1603 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of the proposed amendments to Regulation 1603 will not affect the benefits of Regulation 1603 to the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of the proposed amendments to Regulation 1603 will not have a significant adverse economic impact on business.

The proposed amendments to Regulation 1603 may affect small businesses.